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Ideas with impact

Income or capital?

When selling real estate, the tax treatment may not be what you think

Many Canadian taxpayers believe the sale of real estate typically receives a more favorable tax rate than other types of income. This is not always the case, however, and selling real estate can be fraught with issues.

The federal government currently taxes income from the sale of capital property at a 50 percent inclusion rate, which means that only half of the income produced from its disposition is taxed. Capital property is defined in section 54 of the Income Tax Act (Canada) ("ITA") to include depreciable property and any property that results in a capital gain or loss on that property's disposition.

One size does not fit all

The ITA does not define capital property by the type of property sold (aside from depreciable property), but rather by whether any gain is taxed as income or capital. As a result, just because the gain on the sale of a certain piece of real estate is taxed as a capital gain to one taxpayer, does not mean another taxpayer who sells the same or similar piece of real estate receives the same favorable capital gains tax treatment. If a taxpayer is in the business of transacting in real estate, for example, the income is treated as business income, which is fully taxable.

If the CRA considers your gain on the disposition of real estate 'an adventure in the nature of trade'[1], it will tax this income at full income tax rates. CRA Interpretation Bulletin 459 indicates:

"It is a general principle that when a person habitually does a thing that is capable of producing a profit, then he is carrying on a trade or business notwithstanding that these activities may be quite separate and apart from his ordinary occupation. An example is that of a dentist who habitually buys and sells real estate."

Continuing the CRA's example, a dentist who owns a home (excluding his primary residence) and decides to sell it after holding it and earning rental income on it for 10 years is treated differently for tax purposes than a dentist who not only practices dentistry, but also buys and sells homes in his spare time. The former would record any gain on the sale of the home as a capital gain (currently taxable at a 50 percent inclusion rate), while the latter would record it as business income (fully taxable).

Intention is the key

When unsure if you should treat income from the disposition of real estate as income or capital, the Canadian courts indicate the primary factor is your intention at the time of acquisition. If the original intention was a relatively quick flip for a profit, any income is subject to income tax at regular business rates (fully taxable). If the intention was a long-term investment, the property is considered capital in nature and subject to the current 50 percent inclusion rate.

1 An adventure in the nature of trade is included in the definition of business in subsection 248(1) of the ITA

In Leonard Reeves Incorporated v. MNR[2], the Tax Court of Canada discussed key indicators for primary intention and real estate including:

- If a taxpayer passively purchased real estate with others and played a passive role in the purchase, the intention of the taxpayer will be the same as that of the managing investor – if the manager planned to hold the property long term as an investment, the same treatment should apply to the taxpayer in question.
- The fact that a sale was not advertised and the taxpayer accepted an unsolicited offer should be looked at in conjunction with other evidence and is not the deciding factor in any decision.
- A taxpayer with a history of trading in real estate will likely have any gains treated as income unless proven otherwise.

Other factors to consider

Also influencing the characterization of a real estate sale as income or capital:

- The length of time the real estate was held – the longer the holding period, the more likely it was held as an investment and so any gain should be taxed as capital.
- Dealers in real estate generally won't lease out the property while owning it for future resale – they prefer to keep the property empty to maintain its fresh, first-hand appeal.
- Dealers in real estate generally do not mortgage a property with closed long term mortgages – they prefer open mortgages with short terms, which is more indicative of a business loan.
- The type of real estate sold is indicative of the intention of the transaction – certain types of real estate may be highly marketable or trending and attractive to short-term investors, signaling any gains should be taxed as income.
- The motivating factors for the disposition may shed light on how the income should be characterized.
- If the transaction is related to another business of the same taxpayer, these factors should be evaluated.

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2 Leonard Reeves Inc. v. Minister of National Revenue, 1985 CarswellNat 357, [1985] 2 C.T.C. 2054, 85 D.T.C. 419 (Tax Court of Canada)

Taxpayers looking to sell real estate should first assess all the criteria that distinguish their situations, where any income from the disposition of real estate is taxed on account of either income or capital – so they can make the most tax effective decisions possible.

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